DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0727
Sales and Use Tax
For the Years 2006 and 2007

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ISSUES

I. Use Tax – Electricity Utility Exemption – Chiller Rooms.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-3-4; 45 IAC 2.2-4-13; Sales Tax Information Bulletin 55 (May 1989); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 359 (Ind. Tax Ct. 1997); Indiana Dep't of State Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003).

Taxpayer protests the imposition of use tax on equipment used in chiller rooms.

II. Use Tax – Imposition – Lease of Tangible Personal Property.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-2.5-4-10; IC § 6-8.1-5-1.

Taxpayer protests the imposition of use tax on a deemed lease of tangible personal property.

III. Use Tax – Imposition – Telecommunication Maintenance Agreement.

Authority: 45 IAC 2.2-3-20; 45 IAC 2.2-3-19; Sales Tax Information Bulletin 2 (December 2006).

Taxpayer protests the imposition of use tax on its purchase of a telecommunications maintenance agreement.

IV. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is a wholesaler of fruits and vegetables. Taxpayer coverts raw fruit and vegetables into prepackaged ready-to-eat food. Taxpayer's customers are primarily grocery retailers. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2006 and 2007. Pursuant to the audit, Taxpayer was assessed additional use tax, interest and penalty. Taxpayer protested the assessments. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Use Tax – Electricity Utility Exemption – Chiller Rooms.

DISCUSSION

The Department's audit found that Taxpayer purchased electricity without paying sales tax. The Department's audit found that at the time of purchase Taxpayer did not have a valid ST-109 exemption certificate. Taxpayer received its electricity from a single meter for the fresh cut areas (production), its warehouse, and its offices. A utility study was performed. There was agreement between the Department and Taxpayer on some items, however the Department's audit made several adjustments such that it found 39.5425 percent of the electricity to be directly involved in direct manufacturing and thus exempt. The remainder of the purchased electricity, 60.4572 percent, was assessed for use tax. Taxpayer protests that the correct exempt percentage is 47.1458 percent when the chilling rooms are classified as production, as Taxpayer protests they should.

The Department's audit states:

> The equipment used in rooms to store raw material and finished goods is disallowed. The equipment includes: refrigeration equipment, some compressors, condenser, evaporators, and defrost heaters. This equipment was used in rooms to store raw materials and finished goods.
>
> During the field inspection, the field examiner found the refrigeration units not to be production since no changes to the products form or substance were made. The energy used to chill the product was not directly involved in direct manufacturing.

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

In accordance with IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on Indiana retail transactions unless a valid exemption is applicable. IC § 6-2.5-4-1 provides that a retail transaction involves the transfer of tangible personal property. Indiana imposes a use tax on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2; 45 IAC 2.2-3-4. IC § 6-2.5-3-4(a)(2) allows for a use tax exemption for property that is acquired in a transaction that is exempt from

sales tax under IC § 6-2.5-5, and the property is being stored, used, or consumed for the purpose for which it was exempted. One of those exemptions is found at IC § 6-2.5-5-5.1, which states:

> (a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.
> (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

Also, 45 IAC 2.2-4-13 explains:

> (a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to tax.
> (b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.
> (c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.
> (d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.
> (e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses.
> (Emphasis added.)

Some areas of Taxpayer's facility are dedicated to chilling cut fruit prior to packaging and other areas are dedicated to reducing the temperature of the fruit prior to cutting. Taxpayer argues that the action of cutting fruit, either manually or by machine, substantially increases the temperature of the fruit. If the fruit reaches an unacceptably high temperature, it becomes unmarketable and may constitute a violation of the FDA regulations. Taxpayer states that these areas do not simply maintain the temperature of the fruit and vegetables. The cutting and handling of the fruit and vegetables increases the temperature of the fruit and vegetables subjected to cutting. Taxpayer provided schedules to support this assertion by showing the temperature of batches of fruit and vegetables before, during, and after cutting, and argues that it is not possible to simply lower the temperature of the cutting room itself to a low enough temperature to compensate for the increases during handling, which is why it is necessary to chill the product before and after cutting.

Taxpayer cites to Indianapolis Fruit Co. v. Indiana Dep't of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998) where the Tax Court found that hair nets worn by Indianapolis Fruit's employees in its fruit and vegetable cutting rooms were exempt. Taxpayer argues here that before the Tax Court could determine that the hair nets were exempt, the Court had to determine that the cutting room activities constituted production, which the Court did. As a matter of fact, the Department's audit agrees with Taxpayer. The Department's audit found that Taxpayer's activities in the cutting rooms constituted production. However, the issue here is the percentage of electricity used in production, and in this case Indianapolis Fruit's exemption of the hair nets is not instructive. Or, as Indianapolis Fruit states:

> The inquiry does not end once it has been determined that production is taking place. Taxpayers must demonstrate that the items they claim are exempt are integral and essential to that production.
> Id. at 1384.

Taxpayer points to Mid-America Energy Resources v. Indiana Dep't of State Revenue, 681 N.E.2d 359 (Ind. Tax Ct. 1997) (" MAER") where the process of chilling a product was held to constitute production. However, In MAER the product was chilled and treated water that was distributed to customers to cool and condition the air at their respective facilities. In Indiana Dep't of State Revenue v. Interstate Warehousing, Inc., 783 N.E.2d 248 (Ind. 2003), the Indiana Supreme Court, in overruling the Tax Court, explained how it distinguished MAER from Interstate Warehousing on which the Tax Court had relied in sustaining the taxpayer:

> The Tax Court correctly found that Mid-America was entitled to the exemption at issue in this case on

chemicals it *253 purchased because its operation of chilling and treating water for the purpose of conditioning air in its customers' buildings constituted production of other tangible personal property. Id. at 264. Mid-America chilled and treated water that its customers purchased and used to condition the air in their respective buildings.

In its opinion in this case, the Tax Court compared the factual background of Mid-America but focused only on the chilling processes used by the respective companies. Certainly, Interstate's process for chilling and distributing ammonia is similar to the process Mid-America used for the cooling and distribution of water. We also agree with the Tax Court that both companies distributed their coolants through a closed loop system with similar types of machinery. See Interstate Warehousing, Inc., 764 N.E.2d at 316-317.

However, as discussed in Part I, supra, we conclude that the Tax Court failed to apply the "distinct marketable good" requirement. Interstate primarily provides the service of storing frozen goods. A necessary component of this service is a climate-controlled environment. Interstate's customers did not purchase the processed ammonia-just like White River's customers did not purchase distinct marketable products. In contrast, Mid-America's customers bought-and paid sales tax on-a distinct marketable product: chilled water. The process Interstate uses to achieve an air conditioned environment is incidental to the service of providing storage for frozen goods. Its customers are neither purchasing, nor paying sales or use taxes on the goods used to provide the service.

Interstate Warehousing, Inc. at 252 -253.

Taxpayer, by its own description warehouses fruit and vegetables before and after some of the fruit and vegetables are cut pending its wholesale distribution of these products to its customers. The chilling and refrigeration process are services concomitant with Taxpayer's warehousing function, more like the services in Interstate Warehousing. In support of its protest, Taxpayer documents the rejection of product by some of its customers when the temperature of the product is above a certain temperature range. However, this rejection of product was directed at Taxpayer's transport subsidiary, presumably because the required temperature range was not maintained in the refrigerated trucks Taxpayer uses to transport its product to its customers. This has nothing to do with Taxpayer's production function and is therefore not work-in-process.

The Department's Sales Tax Information Bulletin 55 (May 1989), which deals with the application of sales tax to sales of utilities used in manufacturing or production, offers a couple of examples that provide useful guidance:

EXAMPLE:

The taxpayer is a restaurant that purchases electricity used to power air conditioning and ventilating equipment. The equipment environmentally conditions the kitchen area of the restaurant. The equipment is not exempt under 45 IAC 2.2-5-8 through 45 IAC 2.2-5-11 because it does not operate in an integrated fashion with the food production process and is not essential to making that process possible. Consequently, the electricity used in conjunction with that equipment is not exempt under Indiana Code 6-2.5-4-5.

Manufacturing or production does not include maintenance, servicing, or repairing of equipment, or testing, handling, shipping, receiving, or storing the finished product. (Utilities used for testing during the production process are exempt.) Utilities used for general space heating or air conditioning, general lighting (including security lighting), movement of goods outside the production process, in offices, or in providing for employee health or comfort are taxable.

Restaurant food heating or cooling is taxable unless it is used in the actual production and creation of the food. Utilities used for warming tables and refrigeration areas are taxable unless the food is undergoing a change due to this process. Refrigeration for storage is a taxable use of the utilities.

EXAMPLE:

Utilities serving a freezer used only in making ice cream or a fryer used for cooking would be exempt. Utilities serving a refrigerator or heat lamp used to keep the products or the raw materials in the same condition are taxable.

(Emphasis added).

Chilling Taxpayer's fruits and vegetables is not actually creating a food product, such as setting the custard in a custard pie, but rather is incidental to warehousing Taxpayer's customer's products.

FINDING

Taxpayer's protest of this issue is respectfully denied.

II. Use Tax – Imposition – Lease of Tangible Personal Property.

DISCUSSION

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions involve the transfer of tangible personal property. IC § 6-2.5-4-1. A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC

§ 6-2.5-3-2(a). A lease transaction is defined as a retail transaction subject to the sales tax. IC § 6-2.5-4-10. The provision of a service is not defined as a retail transaction. Therefore, the provision of a service is not subject to sales or use tax.

In the 1990s, a transportation subsidiary of Taxpayer entered into a lease arrangement with an unrelated third-party ("Lessor"), whereby the transportation subsidiary leased 60-70 trucks/semi-trailers from Lessor in order to transport Taxpayer's products to Taxpayer's customers. According to Taxpayer, it was the guarantor of this truck lease arrangement. Sometime in 2006, it was decided Taxpayer's transportation subsidiary would no longer transport Taxpayer's product, but Lessor refused to cancel the lease contract. Taxpayer in the meantime contracted with an unrelated transportation company ("Carrier") to transport Taxpayer's product to Taxpayer's customers. However, since Taxpayer was the guarantor on the lease agreement, and because Lessor refused to cancel the contract, Taxpayer was obligated to fulfill the contract with Lessor under the terms of the original lease agreement. According to Taxpayer, Lessor agreed to accept payment directly from Carrier and allowed Carrier to operate the leased trucks. Carrier in turn invoiced Taxpayer for the lease payments as a separate charge from its transportation services charge.

The Department's audit found that for the years at issue Taxpayer leased trucks/semi-trailers from Lessor. The Department's audit assessed use tax on this lease of tangible personal property. The Department's audit noted that Taxpayer decided to have its transportation needs met by an outside vendor, Carrier, and that Taxpayer made lease payments to Carrier during the years at issue, as evidenced by invoices from Carrier to Taxpayer which stated separate charges for the lease payment and the transportation services. In correspondence with Taxpayer, the Department's auditor cites to Appendix A-Revision 3 ("Appendix"), page 3, paragraph 14, of the contract, dated September 22, 2007, between the vendor and Taxpayer:

> [Taxpayer] will furnish 53 tractors and 10 reefer straight trucks. The power units will be leased from [Lessor]. [Taxpayer] will be responsible for all lease expense and power unit related expenses with the exception of insurance, fuel, and drivers. These three factors are included in [Carrier]'s rate structure. [please note that this language is the same as the prior version of this appendix that was in place in 2006].

The Department's audit concluded that this was a lease between Taxpayer and vendor. The fact that the original lessor would not release Taxpayer from its lease, but did agree to invoice the new vendor directly. The Department's audit concluded that the assignment of rights and delegation of duties does not release Taxpayer from its retail sales tax obligation for these transactions.

Taxpayer argues that the Department incorrectly deemed Taxpayer to be the lessee in this arrangement, and, therefore, incorrectly subjected Taxpayer to use tax on a lease of tangible personal property. Taxpayer argues that Taxpayer was simply the guarantor of the original lease and that when Lessor agreed to transfer operation of the trucks to Carrier, "the effect was to create a new lease between [Carrier] and [Lessor]." Taxpayer also presents arguments under two alternate theories – assignment and sublease – to demonstrate that the lease relationship is between Lessor and Carrier. However, neither of these arrangements is memorialized in writing, nor are the terms of either arrangement predicated by terms in the original lease agreement that dates back to 1995. By Taxpayer's own words, it was the guarantor of the original lease agreement. Again, there is no written document that explains specifically Taxpayer's role as guarantor. Absent such explanation, the presumption is that when Taxpayer's transportation subsidiary, who was a party to the original lease agreement, chose to renege on the arrangement, Taxpayer, as guarantor, was obligated both financially and otherwise to step in for its subsidiary.

Paragraph 21 of the lease agreement, under the heading "Transfer of Vehicles or Assignment of Lease," no related changes can be made without Lessor's prior written consent. Taxpayer has not presented any such writing. Taxpayer did present a letter dated February 24, 2009, in which Lessor memorializes a conversation that "all parties" had in September of 2006 where Lessor agreed "to accept payment directly from [Carrier] for all weekly invoices from [Lessor]" and where Lessor agreed "that the leased equipment would be operated by [Carrier] as a dedicated carrier for [Taxpayer]." The letter was addressed to Taxpayer's old transportation subsidiary, for whom Taxpayer is the guarantor. Even assuming this writing is a good faith representation of the arrangement between "all parties," all it actually states is that Lessor accepts payment directly from Carrier and that the leased equipment would be operated by Carrier. In other words, two functions are assigned to Carrier: direct payment to Lessor and operation of the trucks – the lease itself has not shifted to Carrier.

Given all of the above, Taxpayer has not met its burden to show that the Department's audit's determination that Taxpayer was leasing trucks from Lessor is incorrect.

FINDING

Taxpayer's protest is respectfully denied.

III. Use Tax – Imposition – Telecommunication Maintenance Agreement.

DISCUSSION

The Department's audit assessed use tax on invoices for a telecommunications warranty contract. The Department's explanation of the adjustment on page 6 of the audit report is one generalized to 45 IAC 2.2-3-20 which subjects all purchases of tangible personal property stored, used or consumed in Indiana to use tax. The Department's audit further states, under the authority of 45 IAC 2.2-3-19, that if the seller does not properly collect

sales tax on the sale, then the purchaser is required to remit use tax. However warranty/maintenance contracts require, under the Department's guidelines (see Sales Tax Information Bulletin 2 (December 2006)), further analysis of the nature of the contract and the terms relating to the provision of tangible personal property in the agreement before they can be subjected to sales or use tax. The Department's audit does not specifically address these elements.

FINDING

Taxpayer's protest of the assessment of use tax on its telecommunication maintenance agreement is sustained.

IV. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
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> The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:
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> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has affirmatively established, as required by 45 IAC 15-11-2(c), that its failure to pay use tax on the items protested was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest of the imposition of negligence penalty is sustained.

CONCLUSION

Taxpayer's protest of the percentage of non-exempt electrical consumption is denied.

Taxpayer's protest of the imposition of use tax on the lease of trucks/semi-trailers is denied.

Taxpayer's protest of the assessment of use tax on its telecommunication maintenance agreement is sustained.

Taxpayer's protest of the imposition of the ten percent negligence penalty is sustained.

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